

Message Text

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ACTION EUR-12

INFO OCT-01 ISO-00 SP-02 USIA-06 AID-05 EB-07 NSC-05
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FM AMEMBASSY ROME
TO SECSTATE WASHDC 5247
TREASURY DEPT WASHDC
INFO AMEMBASSY BONN
AMEMBASSY BRUSSELS
AMEMBASSY LONDON
AMCONSUL MILAN
AMCONSUL NAPLES
AMEMBASSY PARIS
AMCONSUL GENOA

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USOECI, USEEC

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TAGS: EFIN, IT, IMF

SUBJECT: POST-IMF STANDBY STATUS REPORT

REF: ROME 8942

1. SUMMARY. ECONOMIC INDICATORS SUGGEST THAT SLOWING IN GROWTH
OF GDP, COUPLED WITH IMPROVED BALANCE OF PAYMENTS AND
DECELERATING INFLATION, SEEM TO BE EVOLVING AS EXPECTED.
FACT THAT MOST IMF STANDBY TARGETS RELATE TO TWELVE-MONTH
PERIOD WHICH ONLY BEGAN APRIL 1 MAKES IT DIFFICULT,
AS YET, TO EVALUATE WHETHER ITALY WILL SUCCEED IN MEETING
ALL THESE TARGETS. FOLLOWING APPROVAL OF IMF STANDBY ON APRIL
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25. DEVELOPMENT OF FURTHER ECONOMIC PROGRAMS HAS SLOWED WHILE
POLITICAL PARTIES AND GOVERNMENT PROBE TO REACH AGREEMENT ON
A NUMBER OF ISSUES. END SUMMARY.

1. ECONOMIC DEVELOPMENTS. LATEST PUBLISHED CY 1977
GOI FORECASTS CALL FOR 2 PERCENT REAL GROWTH OF GDP,
AVERAGE PRICE DEFULATOR OF SLIGHTLY LESS THAN 20 PERCENT

AND BALANCE OF PAYMENTS DEFICIT ON CURRENT ACCOUNT OF ABOUT 500 BILLION LIRE (ABOUT \$565 MILLION). THESE ESTIMATES DO NOT DIFFER SIGNIFICANTLY FROM EMBASSY'S OWN FORECASTS OF REAL GROWTH (2.0 TO 2.5 PERCENT), DEFLATOR OF 18.5 PERCENT AND CURRENT ACCOUNT DEFICIT OF ABOUT \$950 MILLION. SOME OTHER FORECASTERS ARE NOW SUGGESTING THAT REAL GROWTH COULD BE IN 3-4 PERCENT RANGE, BUT EMBASSY DOUBTS THAT GROWTH RATE WILL REACH THAT LEVEL. STABILIZATION MEASURES TAKEN LATE IN 1976 AND EARLY 1977 TO REDUCE DISPOSABLE INCOME WILL HAVE IMPACT AT DIFFERENT TIMES. FOR EXAMPLE, PUBLIC SERVICE TARIFF INCREASE WILL CONSTITUTE SLOW DRAIN DURING THE YEAR, WHILE PAYMENT OF INCOME TAXES OF BUSINESS AND THE SELF-EMPLOYED WILL IMPACT AT END OF JUNE, WHEN 1976 TAXES MUST BE PAID AND END OF OCTOBER WHEN 3/4 ADVANCE FROM 1977 TAXES ARE DUE. THUS SQUEEZE WILL MOST LIKELY BE FELT ONLY IN SECOND HALF OF YEAR.

2. RECENT DATA ON INDUSTRIAL OUTPUT SHOWS A SLOWDOWN IN GROWTH. SEASONALLY ADJUSTED INDUSTRIAL PRODUCTION INDEX HAS BEEN FLAT FOR LAST FIVE MONTHS (THROUGH MARCH), AND LEADING ECONOMIC INDICATORS PERFORMANCE AND MISCELLANEOUS REPORTS IN BUSINESS COMMUNITY ALREADY SUGGEST A SLOWDOWN IN CONSUMER DEMAND. EXPECTED SLIGHT RISE IN ACTIVITY IN THE FIRST HALF 1977 BUT FALL IN THE SECOND HALF SEEMS TO BE MATERIALIZING. (FIRST QUARTER GDP DATA WILL NOT BE AVAILABLE UNTIL AROUND BEGINNING OF JULY, AND RETAIL TRAD STATISTICS ARE TOO LATE IN PUBLICATION TO BE USEFUL CURRENT INDICATOR.)

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3. IT IS NOT POSSIBLE AS YET TO ASSESS EMPLOYMENT DEVELOPMENTS. CENTRAL STATISTICAL INSTITUTE (ISTAT) BEGAN NEW STATISTICAL SERIES ON LABOR FORCE WITH JANUARY 1977 SURVEY, WHICH IS DESIGNED TO CONFORM TO EC STANDARDS AND WHICH HAS THE EFFECT OF ENLARGING THE LABOR FORCE AND THE UNEMPLOYMENT COMPONENT THEREIN. UNFORTUATELY, HISTORIC SERIES ON NEW BASIS IS NOT YET AVAILABLE TO PERMIT ACCURATE COMPARISONS OF CURRENT AND PAST EMPLOYMENT DATA.

4. DATA ON PRICE MOVEMENTS THROUGH APRIL ARE FAIRLY ENCOURAGING. FOLLOWING INITIAL EFFECTS OF SOME PUBLIC SERVICE AND VALUE ADDED TAX RATE INCREASES (ESPECIALLY IN FEBRUARY), MONTHLY RATE OF COST OF LIVING INCREASE HAS BEEN IN 1.0 TO 1.5 PERCENT RANGE. IN BOTH MARCH AND APRIL WHOLSLAE PRICES ROSE BY ONLY 0.8 PERCENT. STABILITY OF LIRA EXCHANGE RATE DURING THIS PERIOD HAS CONTRIBUTED TO STABILITY OF PRICES OF IMPORTED GOODS, AS HAS RELATIVELY MODERATE PRICING POLICY OF OIL PRODUCERS. FOR 1977 EMBASSY BELIEVES THAT AVERAGE COST OF LIVING

COULD RISE BY ABOUT 19 PERCENT, BUT DECEMBER 1976
TO DECEMBER 1977 RISE COULD BE AS LOW AS 13 PERCENT.

5. BALANCE OF PAYMENTS SEEMS TO BE IN LINE WITH FORECASTS FOR 1977. ALTHOUGH OVERALL BALANCE OF PAYMENTS WAS IN DEFICIT \$2.5 BILLION THROUGH MID-MAY, CUSTOMS DATA FOR FOUR MONTHS SHOW VALUE OF EXPORTS UP 38.5 PERCENT COMPARED TO 29.2 PERCENT FOR IMPORTS. CAPITAL ACCOUNT HAS EVIDENTLY BEEN STRONGLY INFLUENCED BY ADVERSE DEVELOPMENTS IN TIMING OF IMPORT PAYMENTS AND EXPORT RECEIPTS. HIGH LEVEL OF IMPORT ARRIVALS IN LAST TWO MONTHS OF 1976 IS JUST NOW BEING PAID FOR. ON OTHER HAND, THERE HAS BEEN CAPITAL INFLOW FROM LIBYA-FIAT DEAL (\$306 MILLION) AND FROM REPATRIATION UNDER PARTIAL AMNESTY LAW OF ILLEGAL CAPITAL EXPORTS.

6. MOST STRIKING DEVELOPMENT HAS BEEN CONTINUED ENORMOUS LIMITED OFFICIAL USE

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INFLOW OF SHORT-TERM BANK CREDIT, TOTALLING ABOUT \$2.7 BILLION FROM JANUARY THROUGH MID-MAY. (AMOUNT WAS ALREADY ABOUT \$3.0 BILLION AT END-1976.) THIS LARGE CAPITAL INFLOW WAS MOSTLY CAUSED BY HIGH INTEREST RATES IN ITALY COMPARED TO EUROMARKET RATES, VARIOUS FOREIGN EXCHANGE

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AND DOMESTIC CREDIT CONTROLS THAT HAVE STIMULATED FOREIGN BORROWING, AND STABILITY OF LIRA EXCHANGE RATE. THERE HAS BEEN MUCH DISCUSSION OF RISKS IN ACCUMULATING SUCH HIGH LEVEL OF SHORT-TERM BANK DEBTS, BUT BANK OF ITALY (BOI) GOVERNOR BAFFI HAS SUGGESTED THAT CONTINUED HIGH DOMESTIC INTEREST RATES AND EXHANGE CONTROLS SHOULD PROTECT AGAINST SUDDEN OUTFLOW. ALTHOUGH OFFICIAL RESERVES HAVE RECENTLY BEEN CONSIDERABLY BOOSTED BY EXCHANGE MARKET INTERVENTION TO BUY UP EXCESS DOLLARS WHILE HOLDING LIRA RATE STEADY, OVERHANG OF SHORT-TERM BANK DEBT COULD TROUBLESOME IF THERE SHOULD BE UNEXPECTED POLITICAL OR ECONOMIC DEVELOPMENTS WHICH UNDERMINE CONFIDENCE. BALANCE OF PAYMENTS SHOULD BE SEASONALLY STRONG ON BOTH TRADE AND SERVICES ACCOUNT DURING SUMMER, AND GRADUAL UNDERLYING IMPROVEMENT IN LIMITED OFFICIAL USE

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TRADE ACCOUNT SHOULD MITIGATE AGAINST SERIOUS PROBLEM.

7. FINALLY, BOI RESERVES HAVE ALREADY BEEN OR WILL BE BOOSTED BY \$500 MILLION EC JOINT BORROWING IN FAVOR OF ITALY, FIRST (\$104 MILLION) IMF STANDBY DRAWING AND EXECUTED PROCEEDS OF NEW \$200 MILLION EUROMARKET CREDIT (ROME 9241). NONETHELESS, EMBASSY WOULD NOT BE SURPRISED IF BOI WERE TO PLACE SOME LIMIT ON FURTHER BUILDUP OF SHORT-TERM BANK DEBT SINCE EXCESS SUPPLY OF FOREIGN EXCHANGE IS NOT NEEDED IN SHORT-RUN AND COULD UNDERMINE TIGHT DOMESTIC CREDIT POLICY.

3. ACHIEVEMENT OF IMF TARGETS. BECAUSE MOST IMF STANDBY TARGETS REFER TO TWELVE-MONTH PERIOD WHICH BEGAN APRIL 1,1977, IT IS MUCH TOO EARLY TO TELL WHETHER ACTUAL DEVELOPMENTS ARE CONSISTENT WITH ACHIEVEMENT OF TARGETS. EMBASSY BELIEVES THAT BALANCE OF PAYMENTS CURRENT ACCOUNT SURPLUS OF 500 BILLION LIRE IN THIS TWELVE-MONTH PERIOD IS SOMEWHAT AMBITIOUS, BUT NOT OUT OF REACH. AVAILABLE DATA FOR FIRST QUARTER SUGGEST THAT OVERALL DEFICIT WAS HEAVILY INFLUENCED BY REPAYMENT OF COMMERCIAL CREDIT, SO THAT TRADE ACCOUNT AND CURRENT ACCOUNT ARE ACTUALLY SHOWING IMPROVEMENT. MONETARY MOVEMENTS DATA FOR APRIL AND FIRST HALF OF MAY, PLUS LATEST EXCHANGE MARKET INTERVENTION PATTERN,

TEND TO CONFIRM BALANCE OF PAYMENTS IMPROVEMENT, ALTHOUGH IT IS NOT CLEAR HOW MUCH OF THIS IS IN CAPITAL ACCOUNT AND HOW MUCH IN CURRENT ACCOUNT.

9. TREASURY CASH DEFICIT. (BUT NOT INCLUDING DEFICITS OF LOCAL GOVERNMENTS, SOCIAL INSURANCE, HEALTH AND HOSPITALS AND NATIONAL ENERGY AGENCY) FOR FIRST THREE MONTHS OF 1977 WAS QUITE HIGH AT 3,117 BILLION LIRE RELATIVE TO TARGET OF 9,800 BILLION LIRE. WHILE FIGURE IS NOT ENCOURAGING, FULL EFFECTS OF TAX MEASURES HAVE NOT YET BEEN FELT, SO JUDGMENT IS DIFFICULT TO MAKE. ON OTHER LIMITED OFFICIAL USE

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HAND, PROGRESS HAS BEEN MADE IN REDUCING CENTRAL BANK FINANCING OF TREASURY CASH DEFICIT (FOR WHICH 4,000 BILLION LIRE CEILING IS INCLUDED IN EC LOAN CONDITIONS). IMPROVEMENT IN ABILITY OF TREASURY TO FINANCE DEFICIT FROM NON-CENTRAL BANK SOURCES HAS BEEN GREATLY FACILITATED RECENTLY BY CONTINUED HIGH NOMINAL INTEREST RATES ON ORDINARY TREASRY BILLS (BOT'S) AND BY QUANTITATIVE CEILINGS ON BANK LENDING AND HIGH LEVEL OF BANK LIQUIDITY.

10. ONLY JANUARY FIGURE IS AVAILABLE FOR DOMESTIC CREDIT EXPANSION (EC CEILING OF 30,600 BILLION LIRE FOR CALENDAR YEAR AND IMF CEILING OF 30,000 BILLION LIRE APRIL 1977 TO MARCH 1978). THE JANUARY 1977 RISE WAS SIGNIFICANTLY LESS THAN EXCEPTIONALLY LARGE INCREASE IN JANUARY 1976 (1,926 BILLION LIRE AND 5,077 BILLION LIRE, RESPECTIVELY).

11. PROSPECTS ARE ENCOURAGING REGARDING ACHIEVEMENT OF CEILING ON WAGE INDEXATION ADJUSTMENTS. IMF STANDBY ESTABLISHED QUARTELY TARGETS FOR SPECIAL WAGE INDEXATION (SCALA MOBILE) INDEX. FIRST TARGET WAS 150 (ON AUGUST-OCTOBER 1974 BASE). ACTUAL INDEX WAS 149, OR ONE POINT LOWER THAN CEILING.

12. CONCLUSION. ECONOMIC INDICATONS ARE TOO FEW AT THIS STAGE TO PREDICT SUCCESS IN ACHIEVING ECONOMIC TARGETS AGREED WITH IMF. THERE ARE ENCOURAGING SIGNS THAT SOME OF BASIC DISEQUILIBRIA ARE BEGINNING TO STRAIGHTEN OUT, I.E., INFLATION AND BALANCE OF PAYMENTS DEFICIT. NOW THAT IMF STAND-BY AGREEMENT HAS BEEN CONCLUDED AND THERE HAVE BEEN SOME POSITIVE INDICATIONS THAT GOI'S STABILIZATION EFFORT IS TAKING EFFECT, BREATHING SPACE HAS BEEN CREATED IN WHICH GOI AND POLITICAL PARTIES HAVE BEGUN EXTENDED DISCUSSIONS TO SEEK AGREEMENT ON MEASURES PROVIDING FOR LONGER TERM ADJUSTMENTS IN THE ECONOMIC STRUCTURE.

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